

The Problem of Capital Flight from Russia

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Note: This is the final report from a joint project on Capital Flight from Russia undertaken by the Institute of Economics, Moscow, and the Centre for the Study of International Economic Relations, University of Western Ontario, Canada, for which *The World Economy* carried the background papers in symposium format in the July 1998 issue. The report has attracted significant interest, and we are pleased to carry it in the journal.

The Editors

1. BACKGROUND

CAPITAL flight is a phenomenon that has a long history, and in the 20th century it has become a frequent accompaniment to economic, social and political crises in various countries. At the beginning of the 1980s, some Latin American countries (Mexico, Argentina, Brazil, etc.) experienced foreign debt-service crises due to capital flight, so the phenomenon of capital flight became one of the most widely discussed topics for both academic researchers and policymakers.

In the 1990s capital flight attracted the attention of the IMF, the World Bank and other international organisations. Mobility of capital and growing integration of world financial markets explain this, but capital flows showed how they could destabilise an economy (as in Mexico in 1982); and could even trigger chain reactions in international markets (as in Asia in 1997).

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Post-socialist states, such as Russia, that borrow heavily abroad have added new features to experience with capital flight. Our research agenda has tried to measure the scale and explain the mechanisms underlying capital flight from Russia, as well as define its causes and consequences.

A group of Russian and Canadian researches from the Institute of Economics of the Russian Academy of Sciences (RAS) and the University of Western Ontario, Canada, initiated a joint research project to investigate these issues. Massive capital flight from Russia first began right after the start of the economic transformation in the early 1990s, and is still continuing nowadays against the background of prolonged recession and growing external debt. This created a threat of economic instability in the country, and also enhanced the risk of default. Canada does not face a similar problem: there is no capital flight and it has thus far been precluded by Canada's robust banking system, mature national markets and balanced public finance. To a certain extent Canadian experience could give helpful insights for Russian policymakers.

The joint project lasted from March 1997 to September 1998, and the Russian and Canadian economists involved undertook cooperative international research. Along with theoretical issues (what is and how to measure capital flight) and analysis of the Russian situation during 1992–97 (causes, patterns, and effects of capital flight), project participants prepared recommendations for the Russian authorities as to how to prevent capital flight and to stimulate capital repatriation. Participants have also actively promoted discussions, meetings with business communities, held press interviews in Russia and Canada as well as organised press conferences at the beginning and the end of the research project.

During the project, participants had had contact with CIDA, the Moscow office of the World Bank, managers of Russian Government Departments (External Economic Relations and Custom Inspection), Canadian Government Departments and private business (Finance Ministry, Bank of Canada, CIBC, CDIC, Ukraine Corporation). Russian discussions included representatives of the Security Council of RF, the Ministry of Finance, the Bank of Russia, and experts from the Russian Academy of Sciences. The participants have prepared eleven reports (the Russian side presented six reports and the Canadian side five reports) as well as published papers in *Voprosy Ekonomiki*, *Bankovskie Uslugi* (in Russian) and *The World Economy* (in English).

The group of Canadian economists headed by Professor John Whalley included Professors Uzi Segal, Ron Wintrobe, Dan Vincent and Terry Sicular among others. The Russian group included Professors Boris Milner, Vyacheslav Senchagov and Dr Natalia Smorodinskaya from the Institute of Economics of RAS and Professor Lidia Krasavina from the Financial Academy of the Russian Government. Academician Leonid Abalkin, Director of the Institute of Economics of RAS headed the Russian group. The project was sponsored by the UCGF Trust Fund — a partnership of the University of Calgary and the Gorbachev Fund.

This is a report on a two year project which has sought to quantify and better understand the mechanisms underlying capital flight from Russia. The project was concluded in the spring/early summer of 1998, all before the onset of the recent dramatic events in Russia following the announced devaluation of late August. The report does not make recommendations aimed directly at the current situation, although the phenomena we identify are contributing factors to the intensification of present difficulties. As such, our report should be read as background to, and not prescription on, the current situation.

2. WHAT IS THE CAPITAL FLIGHT, AND THE SCALE OF CAPITAL FLIGHT FROM RUSSIA?

Recent economic literature is not always clear as to what constitutes capital flight, and the vagueness of the term both hinders the development of a theory of capital flight, and facilitates the misuse of the term for political purposes. What is the difference between the movement of capital from Tokyo to New York (that we call portfolio investment) and from Mexico to Miami (that is called capital flight)? Why American or German investment in Russia is seen as 'foreign investment' that provides significant capital return to investors, but the movement of private Russian capital abroad is called 'capital flight'?

While the difference in the meaning of the term is subjective, its use can lead to different policy implications. We use the term capital flight to indicate transfers of assets denominated in a national currency into assets denominated in a foreign currency, either at home or abroad, in ways which are not part of normal commercial transactions. Thus, assets transferred abroad into foreign bank accounts or foreign securities which go beyond normal diversification behaviour constitute capital flight, as does activity of domestic residents in holding or hoarding foreign currency (dollars) in place of domestic currency.

When engaging in capital flight, economic agents transfer assets by three methods: The first is transfer of financial assets denominated in a foreign currency abroad. The second is accumulation of financial assets denominated in a foreign currency abroad (particularly, by non-repatriation of profits); and the third is transfer of financial assets denominated in a national currency into financial assets denominated in a foreign currency (internal drain). Identifying capital flight reduces to the problem of identifying that part of the transactions that either by its origin or somehow else may be considered to be abnormal, and hence merit the term 'capital flight'.

Existing literature offers two approaches to be used in making such identification. The first looks at the motivation for various transactions and largely defines capital flight as an adjustment driven by general or currency risk not business specific risk, regardless of whether it takes the form of an external or

internal drain. The second identifies capital flight as that abnormal reduction in investment that affects national economic development (see Appendix A). The best known example of capital flight is a financial panic that results in a massive sell-off of financial assets denominated in a national currency (shares, bonds, etc.) or a run on national banks. When its development is more gradual, we will use the term 'capital leakage' instead.

Taking into consideration these methodological issues, participants in the project came to the following conclusions:

First, capital flight in Russia largely corresponds to what is already discussed in the literature. Capital flight from Russia does not represent normal decisions of profit maximising individuals, and cannot be explained as traditional investment abroad on diversification grounds. Moreover, capital flight from Russia leads to a clear and evident reduction in national investment.

Second, capital flight from Russia has been an ongoing process since the move to a market-oriented economy in the early 1990s.

Third, for operational purposes when discussing the Russian situation, capital flight and capital leakage are equivalent terms. The importance is not the precise meaning of these terms, but rather the effect that capital flight has had on Russian economic development.

As far as the scale of capital flight from Russia is concerned, project participants have found only partial estimates in the existing literature, some of which are presented without clarification of the methodologies used in making calculations. The underlying data situation is equally problematic. It is known, for instance, that the Russian Government does not have reliable data on the volume of exports in real terms. As a result, estimates of capital flight also vary significantly (see Table 1).

We have used balance of payments data of the Russian Federation that are compiled by the Bank of Russia as our starting point. The availability of detailed accounts (both for current operations and for capital and financial transactions) allows direct estimation of the scale of capital flight from Russia. However, statistics of an international standard on the Russian balance of payments were not available at the beginning of economic reform (1992–93), so it is only possible to get approximate estimates based on official statistics of Russian exports and imports for earlier periods. In the Russian case, we have not used an alternative residual method used by the World Bank for developing countries.

Using these procedures, and according to our estimates, capital flight from Russia has run at \$17 billion annually since 1994 (see Table 2), and Russian residents have accumulated about \$68 billion abroad between 1 January, 1994, and 30 September, 1997. This sum exceeds the capital flight from Mexico for nine years in the 1990s (\$60 billion for 1979–87). Our estimates suggest that 33 per cent of this amount comprises illegal capital flight, 37 per cent constitutes semi-legal, and the rest is various financial operations with capital assets.

TABLE 1
Capital Flight from Russia: Alternative Assessments

Source	Cumulative Capital Outflow and/or Foreign Assets Held by Russian Residents Abroad, \$bn
1. <i>Russian Authorities and Federal Departments:</i>	
✓ Gosduma (Committee on National Security Issues)	✓ 200 (outflow) — 1992–96
✓ Ministry for Foreign Economic Affairs	✓ 150–200 (outflow) — 1992–96
✓ General Prosecutor's Office	✓ 40–50 (illegal outflow) — as of January 1997
✓ Ministry of Economics	✓ 230 (outflow) — 1992–97
✓ Ministry of Internal Affairs	✓ 50 (illegal outflow) — as of January 1998, of which 9 — annually
✓ Bank of Russia	✓ 50–70 (illegal outflow) — 1992–95
2. <i>Russian Economists:</i>	
✓ Bulatov A., Senchagov B., Gubin B.	✓ 180–220 (outflow) — 1992–95
✓ Khaldin M.	✓ 150 (outflow) — 1992–94
✓ Loushin A., Sarafanov M.	✓ 43 (assets) — end of 1995, of which 22 are illegally exported assets
✓ Illarionov A.	✓ 51 (assets) — end of 1995, of which 25 are illegally exported assets and 7 — annual illegal outflow
✓ Grigoriev L.	✓ 10 — annual illegal outflow in the 1990s
✓ Khodov L. (with a reference on German experts)	✓ 18 — annual illegal outflow in 1990–94
3. <i>International Financial Organisations and Foreign Experts:</i>	
✓ World Bank	✓ 60 (assets) — end of 1996
✓ IMF and Paris Club	✓ 50 (assets) — end of 1995
✓ Consulting Company 'Coopers and Lybrand'	✓ 60 (assets) — end of 1996

Sources:

Voprosy Ekonomiki (1995, N 11, pp. 153–154; 1996, N 9, p. 14);

Analiticheskie Obozreniya Tsentra Kompleksnyh i Sotsialnyh Issledovaniy i Marketinga (M., 1996, vypusk 1, 15, p. 36);

Moscow News (1996, N 47, p. 9);

Economist (1997, N 11, p. 37);

Bulatov A., *Vyoz Kapitala iz Rosii i Kontseptsiya ego Regulirovaniya* (M., 1997, pp. 30, 58);

Data from Russian Press (*Izvestia*, *Finansovye Izvestia*, *Kommersant Daily*, etc.)

If we add to this amount the capital flight in 1992–93 (which we estimate to be within a range of \$56–70 billion), the total capital flight comprises \$125–140 billion as of September 1997 or, averaged across estimates, \$133 billion (see Table 3). These figures suggest that the amount of capital flight from Russia over this period exceeds the cumulative aggregate capital flight from Brazil, Venezuela, Mexico and Peru over the period 1979–87. We would emphasise that the statistical error of estimate (especially for 1992–93) is large, and these

TABLE 2
Estimation of Capital Flight from Russia, 1994–97, \$bn

	1994	1995	1996	1997*	Total for 1994–97*
1. Non-registered capital outflow (item 'Errors and Omissions')	0.4	7.9	8.1	7.3	22.7
2. Export revenue arrears and uncovered import advances	3.9	4.9	9.8	6.5	25.1
■ excluding transactions with CIS countries:	1.8	5.1	9.0	5.0	20.9
3. Export trade credits and import advances: a difference between offered and raised sums	4.7	0.0	10.3	5.1	20.1
■ excluding transactions with CIS countries:	4.2	–1.5	10.7	3.7	17.1
4. Capital flight: (1)+(2)+(3)	9.0	12.8	28.2	18.9	67.9
■ excluding CIS countries:	4.9	14.4	25.9	16.0	60.7

Note: *Data for 1997 is for the first 9 months.

Sources:

RF Balance of Payments Statistics (Bank of Russia), *RF System of National Accounts* (Goskomstat of Russia), *International Financial Statistics* (IMF).

estimates of capital flight should be viewed as much as an indicator of problems with the Russian economy as precise measures.

3. RUSSIAN CAPITAL FLIGHT: ITS NATURE AND CHARACTERISTICS

Though capital flight from Russia has similar features to that observed elsewhere in the world, it differs somewhat in motives, mechanisms and macroeconomic effects.

The main reason for the flight has been general political and economic instability of the country, particularly in the early transition period that was characterised by the dissolution of the USSR and the imperfectly synchronised introduction of reforms. The main source of capital flight was income of Russian residents obtained through the shadow redistribution of budget funds and individual savings, as well as incomes originating from speculative activities. A multitude of underlying factors that have contributed to the capital flight phenomenon in Russia can be classified as follows:

- (1) High returns on exports of natural resource products during 1992–93, and the ease of using invoicing and other schemes to defer repatriation of

TABLE 3
Capital Flight Ratios in Russia, 1992–97

Indicators (end of period)	1992	1993	1994	1995	1996	1997 ¹
1. Capital flight (annual net outflow), \$ bn	40.0*	25.5*	9.0	12.8	28.2	18.9
As per cent of:						
■ exports of goods and services	60.0**	35.0**	11.8	13.8	27.3	25.8
■ increase of the official external debt	2200.0	510.0	214.0	155.0	361.5	361.0
■ increase of gross fixed capital formation	345.5	90.5	24.0	18.4	33.9	25.3
2. Foreign assets abroad (net stock), \$ bn	40.0	65.5	74.5	87.3	115.5	133.3
As per cent of:						
■ GDP	46.5	37.5	26.5	24.5	26.2	29.2
■ official external debt	40.0	63.0	69.0	75.0	92.5	103.5
<i>References:</i>						
■ GDP, trillion Rbl.	19.0	171.5	611.0	1630.1	2256.1	2675.0
■ gross fixed capital formation, trillion Rbl.	4.5	35.0	133.0	329.4	461.7	438.6
■ official external debt, \$ bn	98.8	103.8	108.0	116.3	124.1	129.3
■ exports of goods and services, \$ bn	53.6**	59.6**	76.2	93.2	103.4	73.0
■ current account balance, \$ bn	9.3	8.0	12.1	3.0
■ ratio of external debt-service payments to exports, per cent	2.4	3.9	7.1	8.6	7.5	6.7

Notes:

¹ Data for the first 9 months.

* Average between minimum and maximum annual estimates: \$38–42 bn (1992) and \$23–28 bn (1993).

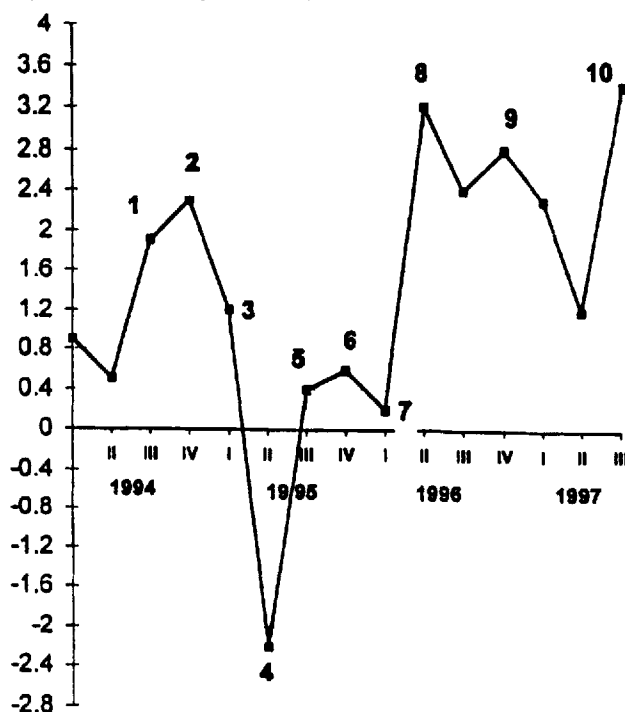
** Data only for exports of goods.

Sources: *RF Balance of Payments Statistics* (Bank of Russia), *RF System of National Accounts* (Goskomstat of Russia), *International Financial Statistics* (IMF).

export earnings due to weak border, customs and foreign exchange controls, and the large margin between national and world prices. A large initial stock of flight capital was built up in this period.

- (2) The large perceived social and political risk associated with maintaining wealth in Russia in a regime with frequent and seemingly arbitrary changes in economic policy. This factor is reflected in the effective dollarisation of the Russian economy (see Figure 1).
- (3) The large redistribution of wealth and income which occurred in the transition period (including the effects of inflation and speculative profits made on financial markets). The effective transfer of wealth abroad through non-repatriation of foreign trade related income has become especially widespread, and has also served to conceal the origin of income and/or to evade taxes. Tariff and export tax evasion via the non-repatriation

FIGURE 1
Net Quarterly Inflow of Foreign Currency Cash to Russia, 1994–96, first 9 months of 1997



Notes:

Peaks and Troughs of Dollarisation:

1. Buying-in of dollars under rising inflationary pressures.
2. The 'black Tuesday' effect (crash of the ruble on Moscow Interbank Currency Exchange on 11 October, 1994).
3. Dedollarisation after the cease of practices to finance the federal budget deficit through direct borrowings from the Bank of Russia.
4. The selloff of dollars by firms (due to liquidity shortages) and the following flight from the dollar after a speculative attack.
5. Dollar stabilisation following the reallocation of 'hot' money from foreign currency transactions to ruble securities (after the introduction of target zone exchange rate regime).
6. The 'black Thursday' effect (liquidity crisis on the interbank credit market on 17 August, 1995).
7. Dedollarisation under the target zone regime (when dollar exchange rate dropped below its equilibrium level).
8. Flight from the ruble during the presidential elections in Russia.
9. Flight from the ruble during Yeltsin's illness.
10. Buying-in of dollars after the announcement about coming denomination and possible taxation of foreign currency purchases.

Source: *RF Balance of Payments Statistics* (Bank of Russia).

of income on trade transactions as well as income generated directly from such transactions were especially important.

- (4) The hedging of Russian corporate income against risks of recession and an adverse business environment. By an adverse business environment we mean:

- An unfavourable macroeconomic situation including economic policies on interest rates, credit availability, inflation and other macro indicators;
- Excessive tax rates faced by those who pay taxes, resulting from inefficient tax calculations, and enforcement of payments;
- The problems for the Russian corporate sector in dealing with organised crime and corruption and generally an underdeveloped legal system;
- The underdevelopment of market institutions (particularly in markets for capital, land and real estate).

All the hedging systems used by Russian businesses to reduce these risks and stabilise their incomes have also generated artificial arrears (inter-enterprise, creditor and tax arrears), which have reduced current payments of taxes and wages. The result has been that the main part of current proceeds from business activities have been transferred abroad pending the resolution of these risk factors.

- (5) A high level of national credit risk (the risk of a chain of non-payments that further reinforces the expectation of significant national currency depreciation). Non-payment risk is present at all levels of the Russian economy, covering:
- State finances (the accumulation of internal and external debt);
 - Industry (inter-enterprise arrears and barter exchange, the issuance of non-monetary exchange notes (IOUs));
 - Banking (the accumulation of bad debts and non-monetary exchange notes).

Our studies have found a positive correlation between non-payment risk and capital flight. Moreover, capital flight continues against a background of increased foreign investment (see Table 4), and seemingly different directions in the more recent evolution of the economy do not change our analysis that capital flight continues to occur in Russia under conditions of high business risk.

The multitude of channels through which capital flight can occur is a particularly important feature that distinguishes Russia from other developing and transition economies. Particularly important was that the speed with which new regulations were developed was considerably slower than the speed at which liberalisation of the economy, in the sense of removing previous arrangements, actually occurred. As a result, the capital flight that has resulted should be seen not as a deliberate illegal activity by Russian asset owners and managers, but rather as a behavioural response to avoid inefficient regulation.

TABLE 4
Russia: Capital Flight and Capital Inflow, 1992–97

	1992	1993	1994	1995	1996	1997*	Total for 1992–97*
Capital flight (net outflow), \$ bn	40.0	25.5	9.0	12.9	28.2	18.8	133.3
1. Foreign direct investment, \$ bn	0.7	0.9	0.6	2.0	2.5	5.0	11.8
■ as per cent of capital flight	1.7	3.5	6.7	15.5	8.9	26.6	8.9
2. Foreign portfolio investment, \$ bn	0.0	0.0	9.9	15.7	23.6
(of which GKO-OFZ)	—	—	—	—	(5.9)	(10.7)	(16.5)
■ as per cent of capital flight	—	—	0.0	0.0	35.1	83.5	17.7
(of which GKO-OFZ)	—	—	—	—	(20.9)	(56.9)	(12.4)
3. Total of capital inflow (excluding loans): (1)+(2)	0.7	0.9	0.6	2.0	12.4	20.7	35.4
■ as per cent of capital flight	1.7	3.5	6.7	15.5	44.0	110.0	26.5

Note:

* Data for 1997 is for the first 9 months.

Sources: *RF Balance of Payments Statistics* (Bank of Russia), *RF System of National Accounts* (Goskomstat of Russia), *International Financial Statistics* (IMF).

4. 'THE INTERNAL' CAPITAL FLIGHT, OR THE DOLLARISATION OF THE RUSSIAN ECONOMY

Internal capital flight from domestic currency denominated assets to foreign currency assets is a widespread phenomenon and can be seen in many emerging market economies. For the post-socialist countries it takes the form of the so-called 'dollarisation', that is an active use of US dollars by residents as a means of payment (substitution of currency) and a means of saving (substitution of assets).

Internal capital flight of this form has occurred in Russia since the beginning of the reforms in the early 1990s. The intensity of such internal flight has not weakened despite subdued inflation in the mid-1990s and a reduction of the purchasing power of the dollar. According to our calculations the amount of foreign currency denominated assets in Russia (cash plus deposits) is more than two-thirds of national currency denominated assets in real terms.

The extent of currency substitution is reflected in the ratio of foreign currency cash to national currency cash. The extent of substitution of domestic bank deposits by foreign currency deposits can be seen in the ratio of these deposits to the M2 aggregate (a usual indicator of dollarisation that is used by the IMF). Since both types of dollarisation coexist together, the most representative indicator of the total level of dollarisation is the ratio of foreign currency assets (cash plus deposits) to the whole money flow (broad money plus foreign currency cash), as is shown in Table 5.

TABLE 5
Dollarisation Ratios in Russia, 1992–97

Indicators (end of period, trillion Rbl.)	1992	1993	1994	1995	1996	1997*
1. Foreign currency deposits	3.7	12.1	37.3	55.3	72.0	79.4
■ as a share of broad money, per cent	42.7	29.5	28.8	20.0	19.6	17.6
■ as a share of money flow, per cent	34.2	23.9	21.0	16.4	14.6	12.7
2. Foreign currency cash ¹	2.1	9.6	47.6	62.2	124.5	171.7
(\$ bn)	(5.0)	(7.7)	(13.4)	(13.4)	(22.4)	(29.3)
■ ratio to MO	—	0.72	1.30	0.77	1.20	1.27
■ as a share of money flow, per cent	19.4	19.0	26.8	18.4	25.3	27.5
3. Foreign currency assets (cash and deposits)	5.8	21.7	84.9	117.5	196.5	250.8
	(14.0)	(17.4)	(23.9)	(25.3)	(35.3)	(42.8)
■ ratio to M2	0.97	0.75	0.92	0.53	0.67	0.67
■ as a share to money flow, per cent	53.7	42.9	47.8	34.8	39.9	40.2
<i>References:</i>						
MO ²	—	13.3	36.5	80.8	103.8	134.8
M2 ³	6.0	28.9	92.4	220.8	294.8	372.2
Broad money ⁴	8.7	41.0	129.7	275.8	366.8	451.6
Money flow ⁵	10.8	50.6	177.3	338.0	491.3	623.3
Exchange rate (Rbl./\$)	415	1247	3550	4640	5560	5860

Notes:

* Data for the first 9 months.

¹ Inflow to household and non-financial firms.

² MO — national currency cash in circulation outside the banking system.

³ M2 (money in circulation) includes MO as well as domestic currency assets held by residents (households and non-financial firms only) at settlement, current and deposit accounts in banks (according to the definition of the Bank of Russia since 1998).

⁴ Broad money includes M2 and foreign currency deposits in the national banking system (i.d. money plus quasi-money).

⁵ Money flow includes broad money and foreign currency cash.

Sources: *RF Balance of Payments Statistics* (Bank of Russia), *RF System of National Accounts* (Goskomstat of Russia), *International Financial Statistics* (IMF).

The dynamics of the dollarisation process during 1992–97 shows three peaks and two troughs (see Table 5). The first and most powerful peak occurred in 1992 when the ratio of foreign currency assets to the cash money flow was 53.7 per cent and over 90 per cent against the M2 aggregate. The level of foreign deposits in the broad money aggregate rose up to 42.7 per cent (compared with 16.7 per cent in 1991). In this respect Russia was a leader among the transition economies, apart from Lithuania (44.7 per cent) and Slovenia (44.4 per cent).

There was then a slowdown in internal flight in 1993, but in the next year a further jump in dollarisation occurred in response to 'Black Tuesday' (in October) on the Moscow Inter-bank Foreign Exchange.

In 1995, on the contrary, a sharp reduction in dollarisation was observed: its level fell by 13 per cent (maximum for the period of 1992–97) due to speculative

attacks on the dollar. Our data show that in the second quarter of 1995 a unique situation occurred when flight from the dollar to the ruble amounted to \$2.2 billion (see Figure 1).

In 1996 and the first nine months of 1997, Russian residents bought \$14.9 billion of foreign currency cash — twice the amount of dollars purchased in the previous four years. This further surge in dollarisation can be explained by political events (the presidential campaign and the health problems of President Yeltsin), as well as by distortions in the banking sector and by expectations of a ruble devaluation in 1997.

Our data indicate several key features as underlying this experience with dollarisation in Russia. *First*, the data show that since the third year of the reforms the preferences of residents regarding foreign currency assets have shifted in favour of cash, so that the inflow of foreign cash into the economy has become larger than the inflow of deposits. It was therefore householders' and business activities in the informal sector which determined the extent of dollarisation in 1994–97. So the ratio of foreign currency deposits to the M2 aggregate used by the IMF to represent the extent of dollarisation no longer corresponds to the Russian situation.

Second, a shift of preferences in favour of cash as well as the appearance of new markets for investments denominated in rubles (stock and real estate markets) has also revealed a difference in portfolio dynamics. Table 5 shows that while the official Russian economy has moved towards de-dollarisation during the last five years (the level of dollar deposits was continuously falling), cash substitution has nonetheless accelerated. The purchase of foreign cash by residents reversed the aggregate trend of the official economy, and high levels of dollarisation were sustained during 1994–97 (in 1997 the foreign currency component in the money flow aggregate was above 40 per cent, of which 27.5 per cent was in cash).

Third, while the scale of dollarisation in Russia was initially correlated with inflation and the exchange rate, since the mid-1990s these correlations have become weaker. Other factors, including speculative motives, have played a larger role. The dollarisation peak in 1996–97 showed that subdued inflation and a strong national currency were not sufficient to achieve reversed substitution.

In mid-1995 Russia adopted a target zone exchange rate regime (the so-called 'currency corridor'), with the ruble floating within a range 5,500–6,100 Rbl. per \$. At the end of 1996 the range was 5,750–6,350 Rbl., and at the end of 1997 it was 5.25–7.15 Rbl. The Russian Consumer Price Index grew by 21.8 per cent in 1996 and 11 per cent in 1997, below the 40 per cent level that is usually taken to characterise high inflation. During this time, dollarisation took the shape of 'hot money' reacting to every slight change in the political and economic situation (see Figure 1).

Why did monetary stabilisation in Russia not lead to de-dollarisation? First, it is likely that high inflation itself had already discredited the national currency:

economic agents had experienced losses in the value of ruble deposits, a collapse of financial pyramids (MMM, e.g.), bank crashes and arbitrary handling of deposit rates. The hypothesis is of a Latin American type syndrome (of deep distrust in the national currency). This is supported by the behaviour of personal savings in Russia in 1992–97: according to V. Popov holdings of ruble denominated financial assets in Russia shrank from 20 to 6–8 per cent of all assets. Second, to Russian residents the resort to dollarisation seemed justified by the risk of a general default in the Russian economy, that is the risk of devaluation and political changes. Third, specifically Russian factors also supported a high demand for dollars, particularly in the scale of the informal sector and the size of ‘shuttle’ trade (unorganised imports). According to official estimates, ‘shuttle’ traders account for around 14.5 per cent of total imports and consume as much as \$10–15 billion of cash annually.

Taking into consideration the scale and character of dollarisation in Russia, when 40 per cent of money flow is denominated in dollars and the net inflow of dollar cash into the Russian economy regularly exceeds the net inflow of ruble cash, what should be done? Clearly the fundamentals of the situation need to be addressed. First, the unpredictability of the monetary substitution both for cash and deposits limits control over M2 through changes in the exchange rate within the currency corridor. This situation increases business risk and ultimately threatens economic stability. Second, the availability of large amounts of liquid financial assets, including bank deposits, reinforces speculative motives for capital flight. It increases instability and raises the risks of financial panics. Third, Russian residents continue to accumulate foreign currency (the purchase of foreign currency accounted for 21.6 per cent of private consumption spending and up to 80 per cent in private savings in 1997). At the same time, they reduce the holdings of ruble denominated financial assets (2.3 per cent in private consumption in 1997 and 4.9 per cent in 1996). This situation is unfavourable for generating real investments in the economy, since savings generated in Russia largely go to hold paper issued by foreign central banks.

5. THE NEGATIVE EFFECTS OF CAPITAL FLIGHT FROM RUSSIA

Capital flight from Russia has a number of adverse consequences for the performance of the Russian economy.

1. The loss of potential resources to finance real investment

Initially, capital flight from Russia occurred because of unfavourable investment climate (high inflation, and the absence of a clear market for inevitable funds). As a result, a significant part of potential Russian investment

was accumulated abroad. Cumulative capital flight comprised perhaps a quarter of Russian GDP by 1997, the amount of external Russian debt which had been taken on (see Table 3). These are large amounts of resources that could have financed Russian investment programmes, and have potentially left Russia for the longer term. Furthermore, continuing flight and dollarisation prevents the accumulation of industrial investment, which supports further economic stagnation.

2. A negative effect on the balance of payments

Data in Table 3 suggest that capital flight constitutes perhaps a quarter of Russian export income and more than four times the payments needed to service the Russian external debt. This situation negatively affects the Russian current account balance.

In 1995 and 1996 the current account balance was positive (\$8 billion in 1995 and \$11.6 billion in 1996). However, a negative tendency revealed itself in 1997 and capital flight became a major factor behind a potential ruble devaluation and the budget deficit.

3. Fictitious capital and the increasing risk of arrears

As flight capital moves between Russia and abroad, it hinders the accumulation of domestic savings and also attracts part of would-be investment capital. This migration also involves part of the external loans that the Russian government must borrow to restructure industry and infrastructure.

Half of the deficit of the Russian federal government is covered by external loans, and part of the credit given either to the government directly or through government guarantees does not reach its supposed destination, but is used on financial speculation and leaves Russia again as fresh flight capital. These possibilities are intensified by the multiplicity of accounts that the departments of the Ministry of Finance as well as commercial banks have. Spending through them is, in part, non-transparent.

This situation is dangerous because of the huge accumulation of unpaid debts at all levels of the economy (state, enterprises and banks). The migration of capital abroad enhances expectations both of inflation and a non-payment crisis. As a result, expectations are, to some degree, self-fulfilled, with capital flight reproducing itself and leading to further stagnation of the investment market.

4. 'Hot money' as a factor in foreign exchange destabilisation

Flight capital along with dollarisation has led to 'hot' money that quickly shifts from one currency to another, even if the asset does not leave Russia. The events

at the end of 1997 that were marked by financial panic in Russia precipitated by Asian and other financial crises have revealed the dangers of speculative pressures on the ruble and Russian financial asset markets.

The exodus from Russian stock (when the price of Russian stocks decreased) and government bond markets (while the margin on bonds increased) coexisted with a large buyout of dollars (half of the annual purchases of dollars were made in the last quarter of 1997) as well as a transfer of foreign financial assets abroad. As a result, Russia has witnessed its first encounter with the more classical form of capital flight, 'hot' money and destabilisation of foreign exchange markets. This new form of capital flight has become an independent factor, dangerous for the longer-term health of the Russian economy.

5. A move towards rent extraction

The unpredictability of 'hot' money that flows in and out of the Russian economy also creates a monitoring problem for the Russian government, when they try to find strategic investors for important development programmes. 'Hot' money has a short-term speculative horizon, unlike foreign development capital which has a long-term objective. 'Hot' money also extracts rents, creating pressures for subversion of budgeting practices in the state, and other undesirable outcomes.

6. WHAT TO DO ABOUT CAPITAL FLIGHT

As we mention in our introduction, this report is based on two years of work and the early drafts were completed before the dramatic events of late August to early September 1998. These events have raised debate on the issue of whether comprehensive capital controls should be introduced into Russia to combat excess financial volatility from interactions with world markets. Our report, due to these timing problems, is not addressed to these broader issues, which we leave for future work.

Our work does, however, still indicate that independently of recent events, Russia encounters a two-fold problem, capital flight of distinctive Russian form and the disruptive effects of 'hot' short-term money movements. The situation clearly raises policy issues as to an appropriate response.

We would begin by arguing that international experience clearly shows that capital flight cannot be prevented unless the basic reasons for the flight cease to exist. Therefore, in Russia, as elsewhere, first and foremost state actions are needed to create a favourable investment climate, and to generate GDP growth sufficient to discourage the capital flight.

Particularly, as part of an improved climate, we would emphasise investment law and tax reforms, the better operation of land and real estate markets, better bank regulation (the adoption of laws that insure private deposits and prohibit the use of budget funds for spending other than that they are earmarked for, etc.). All of these background measures of wider economic policy will go some way to alleviating the problem.

At the same time, there are measures which we think may be needed to counteract capital flight. The scale of and mobility inherent in modern capital markets casts doubt over whether a sound macroeconomic domestic situation alone may prevent speculative attacks (the financial crises in South East Asia in 1997 are an example). That is why several countries (Chile, South Korea, etc.) have used controls on international movement of capital. These controls put a break on large short-term transfers of financial assets. These controls may take the form of imposing a schedule on the repatriation of profit, limiting spot purchase of foreign currency, taxes on foreign exchange transactions or prior deposit of a part of foreign credit in national banks.

We are aware of the dangers associated with the imposition of such controls. Modern financial markets offer and constantly develop a wide spectrum of tools that allows the avoidance of government regulation. And even if controls are partially effective, they adversely affect the flow of foreign investment and deprive the country of the benefits of freer trade in factors.

Experience elsewhere shows that effectively counteracting short-term speculative pressure from 'hot' money can prevent heightened expectations of devaluation although this may only be temporary. The Russian success in dealing with the crisis at the end of 1997 stands in contrast to recent events. Successful actions may be either short term (timely foreign currency intervention, temporary credit regulation) or long term, such as stimulating domestic savings, accumulating foreign reserves in a national bank, etc.

As far as capital outflows by legal channels (i.e. registered in the current account of balance of payments) are concerned, any additional controls over capital flows are irrelevant, and in our opinion not called for. They would deprive Russia of the benefits of internationalisation and would adversely affect economic growth. Even though current external controls are imperfect, they largely satisfy international standards for prudential control (in particular, the rules for international financial and trade organisations).

Hence, in our view, the main focus of policy towards capital flight must be on increasing the effectiveness of existing controls over international trade and foreign currency, the elimination of gaps in federal legislation and the elevation of international cooperation via exchanges of information and other agreements. We see two tasks: to enforce the current legislation and to update laws controlling the legal export of capital. Concerning these two tasks, we suggest the following actions:

- (1) *Rationalising present foreign currency controls over Russian international transactions.* This includes the elimination of duplication of departmental powers (including commercial banks) of those responsible for licensing capital exports. In 1997, foreign currency controls were exercised by the following organisations: The Bank of Russia's Principal Administration of the Foreign Currency Control, MVES, GTK, Federal Services of Foreign Currency and Export Control, Department of Tax Inspection, Ministry of Finance, Ministry of Economics, State Investment Corporation and private commercial banks. The adoption of clearer federal laws over capital exports, as well as resolutions concerning licensing, maintenance and taxation of legal exports of assets. These regulations should be simplified.
- (2) *The introduction of fines for delays in repatriating revenues from exported goods.* For special complex transactions, requiring time for their setup, the payoff term should be extended. Similar actions must be taken for import advances (with a specified delivery time) in order to reduce the number of cancelled contracts.
- (3) *Enhanced control over capital flows associated with barter transactions with contract prices deviating from the world prices.* Such transactions amounted up to eight per cent of the volume of foreign trade by Russia in recent years (including about 25 per cent of the volume of trade with CIS countries). In addition, these transactions are highly unbalanced and are beneficial to foreign suppliers (Russian export exceeds import 5–6 times).
- (4) *Establishing effective legal controls over capital and goods flows inside CIS.* The integration between countries-members of the CIS (the creation of the Customs Union among Russia, BeloRussia, Khazakhstan, Kirgizstan, and from 1998 Tadzhikistan), has not only brought advantages but has also opened the doors to abuse, such as contraband operations and capital flight (using price manipulation in barter transactions, false transit/export documents). Most of the Russian border with the CIS countries (11,800 km) is transparent, and the borders of the CIS are not properly secured.
- (5) *The elimination of illegal channels for capital flight.* The flight of capital from Russia is linked with illegal transactions (contraband, drug business, weapon trade, etc.) which are balance of payments accounts. This aspect of capital flight is not specific to Russia, but is part of the international problem of fighting crime. It requires interaction and information exchange among all countries. The first steps made by Russia in this direction were to sign the Vienna Convention and to become an INTERPOL member. In our view, the next steps should be to sign bilateral agreements with other countries about cooperation in

currency, export and other types of control over the goods and capital flows, and to develop bilateral cooperation between the Russian Security Services and State Control Agencies and the corresponding foreign and international organisations. In particular, we recommend cooperation with the 'Control Risk Group' to find the origins of capital assets and their transfer by criminal groups, as well as GAFI in order to prevent the use of banks and other financial institutions in criminal activities.

- (6) *Stimulating the return of the runaway capital.* Since Russian capital flight presents a loss in resources for economic growth, we reiterate that creating a favourable investment climate in Russia to attract capital back to the country must be a first priority. Inventive schemes could be used to convert some of the Russian liabilities into equities of private Russian enterprises by selling these liabilities to the owners of flight capital on special conditions beneficial for investors as well as for the federal budget. We also believe that there should be negotiations between the Bank of Russia and the Bank of International Transactions (Swiss) about possibilities for bilateral cooperation to stimulate the return of flight capital to Russia.
- (7) *Initiating international cooperation on information exchange and other devices to better track Russian assets abroad.* Particularly important are Russia's negotiated international tax treaties, under which information of foreign tax authorities on foreign assets (and income thereon) of Russian assets can be shared. Such information exchanges are a shared interest with other countries with similar problems (in Latin America, for instance), and hence should be championed in international fora. Such issues should be raised as part of Russia's negotiation accession to the World Trade Organisation, and could be a lead issue in a bilateral negotiation with the EU on a free trade agreement.

APPENDIX A

How to Identify and Measure Capital Flight (Prepared by N. Smorodinskaia)

1. Motivational and Normative Methods for Identifying Capital Flight

There are two alternative approaches in modern Western literature to identify the capital flight phenomenon: motivational and normative.

The *motivational approach* concentrates attention on considering the reasons of economic agents for exporting capital. It treats capital flight as those outflows of capital that are not related to common investors' practices to diversify assets (for the purpose of minimising portfolio risk, increasing portfolio returns by investing abroad, etc.) but are rather caused by increasing country risk (growing

economic and political instability, worsening of macroeconomic fundamentals) and/or expectations of unfavourable changes in economic policies of the government (risks of nationalisation, devaluation, tax increases, strengthening of capital control, etc.).

The motivational approach was originated by Kindelberger (1937) in his classical work *International Short-term Capital Movements*. He defines capital flight as 'abnormal' flows propelled from a country by fears of owners to lose their assets (p. 158). Fifty years later, this definition was updated by Dooley (1986), Lessard and Williamson (1987), Dornbush (1990), Deppler and Williamson (1987) and others.

In the middle 1980s, Dooley formalised the motivational approach by distinguishing between 'normal' and 'abnormal' capital outflows, the latter being considered capital flight.¹ According to Dooley capital flight comprises all legal as well as illegal exports of assets, returns on which never come back to the country (according to official registration). The magnitude of capital flight is thus calculated as the difference between the total foreign assets accumulated by residents abroad, and the non-flight capital (those assets abroad that bring to the country registered investment income):

$$CF = \text{total foreign assets} - \text{non-flight capital}$$

The methodological advantages of motivational approach for identifying capital flight are considered to be as follows:

- avoiding any presumptuous political judgement of capital flight as an unconditionally negative or positive phenomenon in the national development;
- revealing the identity of the capital flight phenomena in different historical periods and economic systems. For instance, this approach can explain the nature of such varied events as the massive outflow of Jewish individual savings from Nazi Germany in the 1930s, the panic selloff of national assets in Latin American countries in the beginning of the 1980s, and the massive leakage of incomes from Russia in the beginning of the 1990s;
- evaluating more precisely potential losses of resources that a country could otherwise use for financing domestic investment and/or foreign debt. For example, the negative influence of capital flight on the country's creditworthiness can be assessed by comparing the amount of capital flight with the amount of official or total external debt of the country;
- revealing the difference of the country risk assessments between residents and non-residents in order to explain situations when capital flight is accompanied by a massive capital inflow into the national economy,

¹ For empirical research see IMF (1991).

including foreign loans (as was the case with Latin American countries in the late 1970s to early 1980s, as is the case with today's Russia).

However, implementing the method of measuring capital flight suggested by Dooley is not always feasible in practice. As empirical research shows, the extremely poor quality of the data on transborder capital flows does not allow economists to distinguish properly between normal and abnormal parts of outflow on the basis of investors' motives.²

The *normative approach* to measuring capital flight defines it in a completely different way. Instead of the origin of the flight capital, it focuses on the macroeconomic consequences of the capital flight, i.e. the negative effect on the country's economic development. This approach, proposed in the 1980s for highly indebted developing countries, estimates capital flight as the direct deduction from the domestic savings needed for financing investment and economic growth.³ Dooley also discusses the damage caused by capital flight to the economic potential of a country. However, he only considers the abnormal part of a capital outflow, while the normative approach treats as a loss any capital outflow from countries with high debt.

2. Narrow and Broad Measures of Capital Flight

Under the normative approach for identifying capital flight, there are two methods of measuring its size — 'narrow' and 'wide'.

The *narrow* definition (Cuddington, 1986) focuses on speculative capital assets ('hot money'), and is given by the sum of net short-term outflows of the non-bank private sector and the 'errors and omissions' item in the balance of payments statistics. The IMF suggests that a high growth of the latter indicates an increase in hidden outflows of resources. If a normal value of the residual is observed, the excess value of the item gives an estimate of the volume of unregistered exports of assets.

A *broad* definition⁴ of capital flight covers outflows of private financial assets, including direct and portfolio investments. According to this method, the value of capital flight is determined by the total change in foreign assets (the increase in the external debt of the country plus the inflow of direct and portfolio investments by foreigners) less any change in official reserves, and deficit in the current balance of payments.

Although the broad measuring of capital flight under the normative approach is easier to implement, economists doubt its application to countries other than indebted developing countries. First, it is hard to use for developed or newly industrialised countries, not to say transition economies, where possibilities for

² Gordon and Levine (1989).

³ Cuddington (1986) and Cumbay and Levich (1987).

⁴ Erbe (1985) and Rodrigues (1987).

profitable investment are absent in the initial stage of reforms, and where capital flight needs therefore a more detailed treatment. Second, the broad definition of capital flight can lead to an over-estimation of its size if the country-debtor does not experience a significant shortage of domestic savings.⁵ Third, even applied to an economy with a shortage of resources, the normative approach ignores cases when the outflow of national assets takes place together with a massive capital inflow.

Given these methodological difficulties in estimating capital flight Lessard and Williamson propose to measure capital flight as the volume of total foreign assets purchased by residents (broad definition), but narrowed according to the nature of such purchases (the motivational approach). Thus, this method provides an alternative to Dooley's approach, but still treats flight capital as an abnormal phenomenon.⁶

3. Estimation of Capital Flight from Russia (1992–97)

To receive quantitative assessments of capital flight from Russia in 1992–97 (see Tables 2 and 3), we had to use two different techniques for the two time periods — 1992–93 and 1994–97 — because of the non-availability of comparable data for the same variables in both periods.

Capital Flight in 1992–93

Data for this period are taken from the RF Foreign Trade Statistics (recently officially revised) and from some expertise provided by the Bank of Russia, and produce rather non-precise estimates. We highlight the following two components of capital leakage in this period:

- (i) *The volume of non-returned revenues from export of goods* — in the amount of \$34–48 bn (\$21–30 bn in 1992 and \$13–18 bn in 1993). This estimate comes from the difference between the State Customs Committee data about the registered exports of the RF to countries outside of CIS and the Bank of Russia data about the export revenues accumulated on residents' accounts in chartered banks.⁷
- (ii) *The volume of contraband exports of goods* — in the amount of \$22 bn (\$12 bn in 1992 and \$10 bn in 1993). Here the estimation reflects the difference between Russia's export potential (exports in 1991, when Russia was a part of the USSR, is taken as a minimum) and the registered exports of goods in 1992–93 to countries outside of CIS.⁸ These data also imply that in countries specialising in exporting fuel resources and raw

⁵ This reflects the view of Dornbush (1990).

⁶ Lessard and Williamson (1987, footnote 1).

⁷ Rossii (1997) and Kommersant (1996).

⁸ Torgovlya (1992) and Rossiyskiy Statisticheskii Ezhegodnik (1997, pp. 577–79).

materials, the pattern of exports (by group of commodities) has high inertia.

Thus, we estimate the cumulative sum of foreign currency profits not repatriated by Russian residents during the first two years of reforms to be between \$56 bn and \$70 bn (see Table 3). We admit that the received volume of capital leakage may be well under-estimated: the scales of manipulation with prices by Russian exporters could be more extreme and the level of possible contraband exports could be higher. However, given the available data, these are the best estimates we are able to produce.

Capital Flight in 1994–97

We have calculated the size of capital flight for this time period using a modified version of Cuddington's method and raising the RF balance of payments data. In particular, we have focused on the following item in the balance of payments statistics:

- (i) '*Errors and Omissions*'. This item reflects the net change in financial demands on non-residents and provides a minimum size of the flight covering the illegal exports of assets. Table 2 illustrates that for the period 1994–96 and nine months of 1997 this item totalled nearly \$23 bn implying large scales of capital flight.
- (ii) '*Export Revenue Arrears and Uncovered Import Advances*'. This item, rarely presented in the balance of payments statistics of other countries, is based on the data provided by the State Customs Committee and by various capital control bodies. It indicates debts of non-residents for goods exported from Russia as well as missing imports in return to the import advances by residents. According to this item (see Table 2) the relevant channels of capital flight from Russia have narrowed significantly after 1992–93, but still the outflow through these channels remains significant — \$25.1 bn (\$20.9 bn excluding transactions with CIS countries).
- (iii) *A difference between the items 'Offered Trade Credits and Advances' and 'Raised Trade Credits and Advances'*. These items reflect the situation with export credits and import advances in the sector of non-financial enterprises. A positive difference between offered and raised sums for the items indicates that Russian enterprises practice to hold abroad (at least temporarily) large amounts of foreign currency by delaying the in-and-out-flow repatriation payoffs. Our calculations for this difference amount to \$20.1 bn cumulatively which clearly shows that Russian enterprises used legal trade practices for misuse purposes of exporting capital assets abroad.

Another channel for capital outflows from Russia — direct and portfolio investments by Russian residents abroad — amounted totally to \$2.6 bn for 1994–97, but we do not consider it to be flight capital. The portfolio investments are undertaken mainly by the Russian banking sector, and the direct investments are made by Russian enterprises (mainly by RAO Gazprom and the oil companies) for the purpose of assets diversification. By the same token, the foreign currency assets held by Russian commercial banks at current and deposit accounts in foreign banks abroad, amounting to \$5.9 bn as of 1 January, 1997,⁹ should not be counted as flight capital.

Thus, according to our calculations, from 1994 onwards, not less than \$17 bn has been leaving Russia every year, allowing Russian residents to accumulate abroad an enormously great stock of assets — around \$68 bn in foreign assets. At the end of 1997, these asset holdings together with the total volume of leakage in 1992–93 created a cumulative stock of flight capital from Russia of between \$125 bn and \$140 bn, or \$133 bn as an average figure.

APPENDIX B

Titles of Research Papers Prepared for the Project

Russian side

‘Economic Crisis in Nowadays Russia and the Problem of Capital Flight’;
‘Capital Flight: Nature, Forms, Methods to Control’ by Leonid Abalkin;

‘Ways to Restrain Capital Flight from Russia and the World Experience’;
‘Methods to Control Capital Flight and to Stimulate the Capital Repatriation’ by Lidia Krasavina;

‘Strengthening of the Ruble, the Payment-Accounting System as the Basis for Dedollarization and the Capital Repatriation to the Russian Economy’; ‘Problems of Russian Capital Flight Estimation and Measures to Prevent Capital Flight’ by Viatcheslav Sentchagov;

‘Forms and Ways of Capital Flight from Russia under Present-day Conditions’ by Boris Milner;

‘To the Problem of Capital Flight’ by Natalia Smorodinskaya;

‘The World Experience About Fighting Against Illegal Capital Export’ by Alexander Lukovenko.

Canadian side

‘Privatization, the Market for Corporate Control, and Capital Flight from Russia’ by Ronald Wintrobe;

⁹ International Investment Position of the Commercial Banks of the Russian Federation as of 1 January, 1997 — *Vestnik Banka Rossii* (1998).

'Capital Flight and Foreign Investment: Two Tales from China and Russia' by Terry Sicular;

'Estimation of Capital Flight from Russia: Balance of Payments Approach' by Konstantin Loukine;

'Punishment Schedules for Capital Flight' by Uzi Segal and Daniel R. Vincent.

APPENDIX C

Articles on Capital Flight Published by the Project Participants

1. L. Abalkin 'Capital Flight: Nature, Forms and Means of Stopping', *Voprosy Ekonomiki* (1998, N 7).
2. V. Senchagov, 'Problems of Capital Flight Prevention', *Ekonomist* (1997, N 11).
3. N. Smorodinskaia, 'Capital Flight as a Subject of International Studies', *Voprosy Ekonomiki* (1997, N 9).
4. N. Smorodinskaia, 'Capital Flight in Theory and Practice: Analysis of Russian Realities', *Banking Services* (1998, N 9).

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